



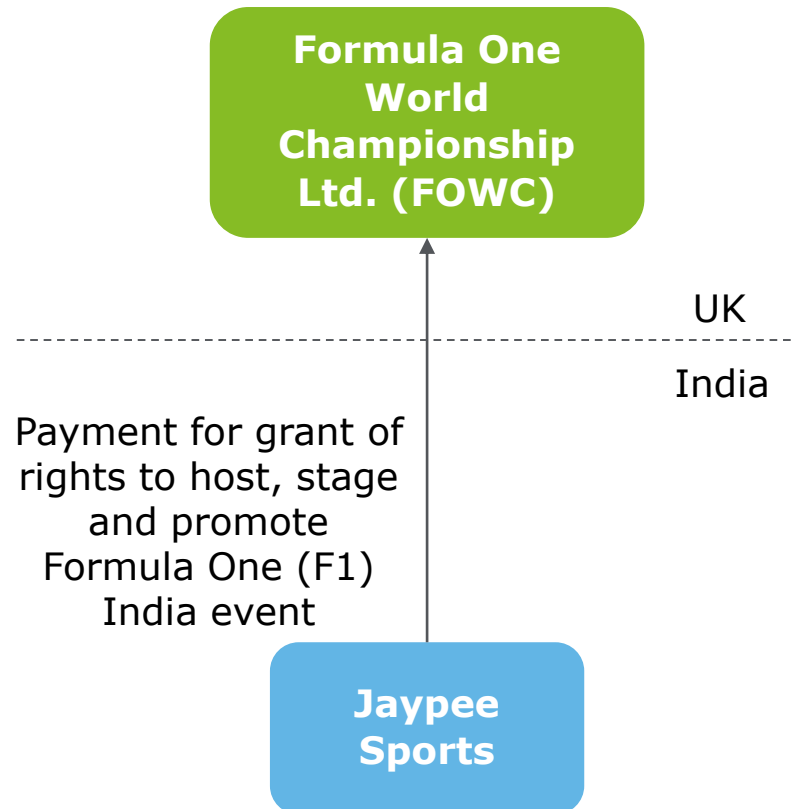
Permanent Establishment and Transfer Pricing Audits:  
Recent Developments  
30 August 2017

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- Recent developments in respect of:
  - Interest on delayed receivables from Associated Enterprise (AE)
  - Advertising, Marketing and Promotion (AMP') expenses and AMP Intensity Adjustment (AIA)

# **Decision of the Supreme Court in Formula One World Championship Ltd. v CIT (80 taxmann.com 347)**

# Formula One World Championship Ltd. 80 taxmann.com 347 (SC)



## Facts

- FOWC is a UK tax resident company
- Consequent to agreements entered into between the FIA, an international motor sports events regulating association, Formula One Asset Management Limited (FOAM/ Affiliate 2) and FOWC, FOAM licensed all commercial rights in the FIA Formula One World Championship to FOWC for 100-year term effective from 1-1-2011
- Participating teams entered into a 'Concorde agreement' with FOWC undertaking to participate in every F-1 event
- FOWC entered into a 'Race Promotion Contract' (RPC) by which it granted to Jaypee Sports, the right to host, stage and promote F1 Grand Prix of India event for a consideration of USD 40 million
- FOWC also entered into an 'Artwork License Agreement' (ALA) permitting Jaypee Sports to use certain marks and IP technology for a consideration of USD 1 million
- On the date of the race FOWC entered into a service agreement with FOAM for providing various services

# Formula One World Championship Ltd. 80 taxmann.com 347 (SC) (2)

## **AAR**

- Both FOWC and Jaypee approached the Authority for Advance Rulings (AAR) and sought an advance ruling on the following questions:
  - Whether the payment of consideration receivable by FOWC outside India in terms of the Race Promotion Contract from Jaypee was royalty as defined in Article 13 of the India-UK tax treaty?
  - Whether FOWC was justified in taking a position that it did not have a Permanent Establishment in India in terms of Article 5 of the India-UK tax treaty?
  - Whether any part of the consideration received or receivable from Jaypee by FOWC outside India was subject to tax deduction at source under section 195 of the Income Tax Act?
- The AAR held that the consideration received by FOWC was for grant of a commercial right and is to be treated as royalty under the India UK tax treaty
- The AAR also held that FOWC did not have a PE in India and since the amount received by FOWC was income in the nature of royalty, Jaypee was liable to deduct tax on the same

# Formula One World Championship Ltd. 80 taxmann.com 347 (SC) (3)

## **Delhi High Court**

- Against the AAR ruling, both FOWC and tax department filed writ petitions before the Delhi High Court
- The Delhi High Court reversed the decision of the AAR and held that the amount paid by Jaypee to FOWC would not constitute royalty under the tax treaty. The High Court also held that FOWC had a PE in India and Jaypee is required to deduct tax from the amount payable to the taxpayer under Section 195 of the Act
- The revenue accepted the ruling of the High Court on the issue of royalty and both FOWC and the tax department preferred appeals to the Supreme Court on the question pertaining to existence of PE, and deduction of tax at source

# Formula One World Championship Ltd. 80 taxmann.com 347 (SC) (4)

## **Supreme Court Findings**

- Article 5(1) provides that PE means a fixed place through which the business of an enterprise is wholly or partly carried on
- Principle test for a fixed place PE is whether the premises are at the disposal of the enterprise i.e. whether the enterprise has the right to use said enterprise and has control thereupon
- Buddh International Circuit is a fixed place
- Various agreements cannot be looked into by isolating them from each other. Their wholesome reading would bring out real transaction between the parties
- FOWC was authorised to exploit the commercial rights directly or through its affiliates only
- By virtue of the Concorde Agreement, the participating teams are bound to engage in the event as per the terms agreed with FOWC
- Under the Race Promotion Contract the rights to host, stage and promote the event are given by FOWC to Jaypee. On the same day, another agreement is signed between Jaypee and three affiliates of FOWC, whereby Jaypee gives back circuit rights, mainly media and title sponsorship

# Formula One World Championship Ltd. 80 taxmann.com 347 (SC) (5)

## **Supreme Court Findings**

- FOWC and its affiliates had complete physical control and access over the circuit
- All the revenues from the aforesaid activities go to affiliates of FOWC. No doubt, FOWC, as CRH of these events, is in the business of exploiting these rights, including intellectual property rights. However, these became possible, in the instant case, only with the actual conduct of these races and active participation of FOWC in the said races, with access and control over the circuit
- The question of the PE has to be examined keeping in mind that the race was to be conducted only for three days in a year and for the entire period of race the control was with FOWC
- Held that the circuit itself constituted a fixed place of business and FOWC carried on a commercial activity through conduct of the races in India
- The Court added that only that portion of the income of FOWC which is attributable to the said PE would be treated as business income of FOWC, subject to deduction of tax under section 195



# Key takeaways and Issues

- Supreme Court reiterates that OECD MC and other international commentaries and jurisprudence can be relied upon for interpreting terms of a tax treaty
- New principles for determination of a fixed place PE or reiteration of principles in the OECD MC?
  - the OECD MC (Abridged July 2014 version) refers to situations where short duration contracts could also constitute a PE
- Substance would prevail over form
  - It is important to understand the substance of the arrangement between parties; to determine who is carrying on what business and the place of business is at whose disposal
- Nature of business has to be examined along with duration of activity for determining existence of PE
  - the Supreme Court has decided the issue based on the nature of the business of the taxpayer which entails performance of revenue generating activities for shorter duration of time, and therefore the six months threshold for the purpose of application of Article 5(1) cannot be taken for granted

# Key takeaways and Issues

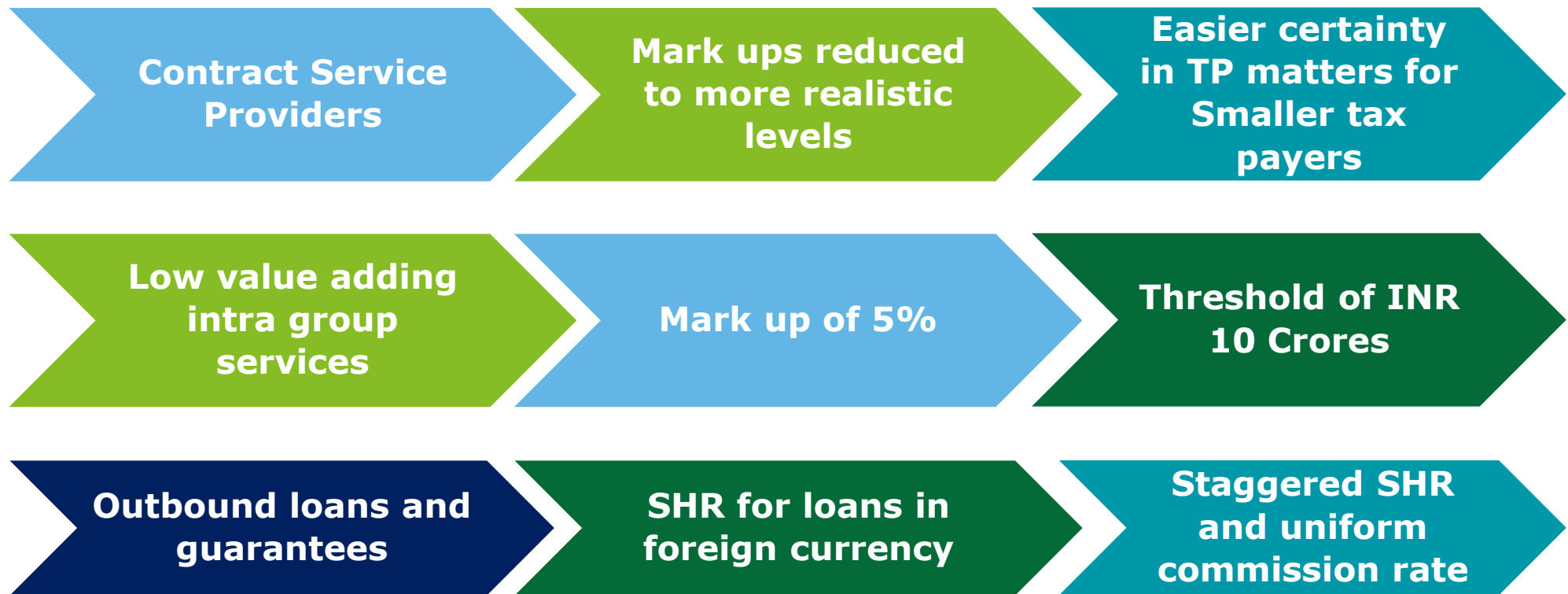
- Exclusivity of short duration business in a country
  - The argument which can be taken by tax payers in such cases could be that the activities performed in India do not constitute the whole of the business
- Nature of business and recurring activities
  - Does this ruling give new ammunition to the tax authorities?

# Recent developments

## Impact on transfer pricing assessments

# Safe Harbour Rules, 2017

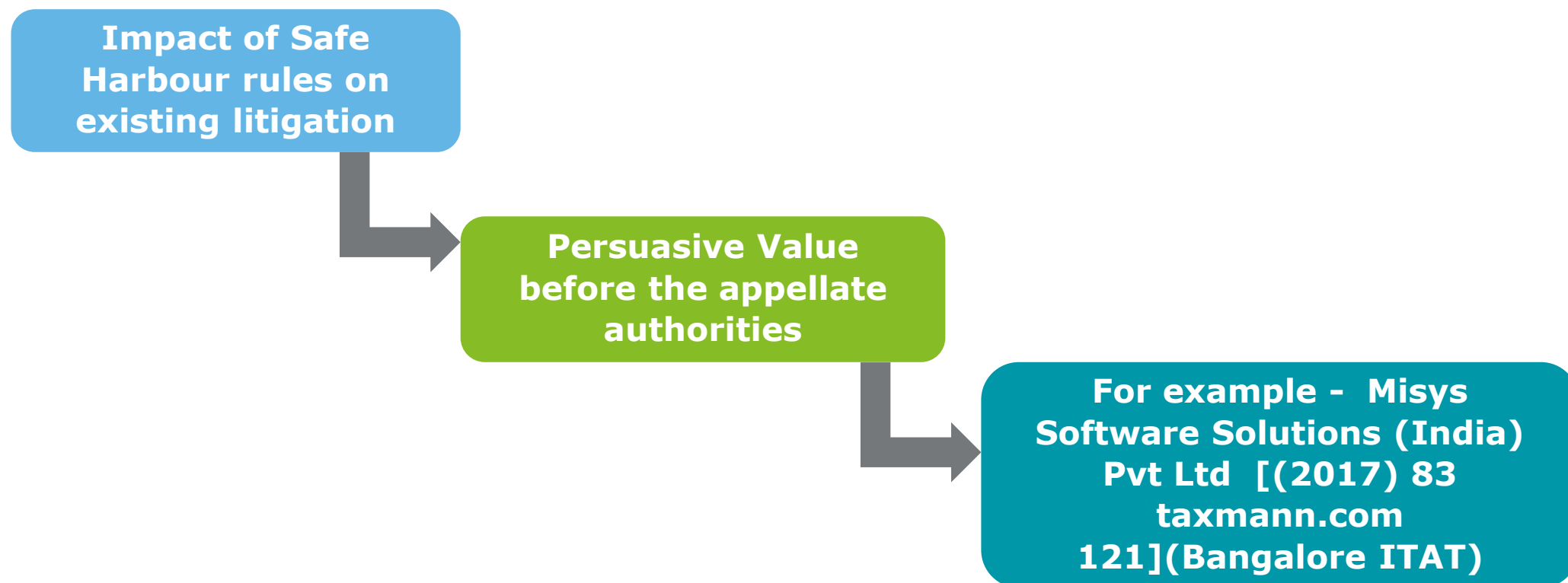
- Revised Safe Harbour Rules notified on 7 June 2017 vide notification 46/2017
- Applicable from FY 2016-17 to FY 2018-19



**The revised Safe Harbour Rules may result in reduction of litigation in small and medium taxpayers**

# Safe Harbour Rules, 2017

## Impact on existing litigation



**The Bangalore tribunal has taken cognizance of safe harbour rules in inferring that now the department also concurs that size of the turnover impacts profit margin even in the case of service sector**

# Advance Pricing Arrangement ('APA')

## Impact on transfer pricing litigation

Indian judiciary has in some recent cases have ruled that the benefit of APA can be extended to other years also – beyond the rollback years:

- **Ameriprise India Pvt. Ltd. (Delhi High Court)** – applied treatment of forex gain/loss based on subsequent year's APA
- **Ranbaxy Laboratories Ltd. (Delhi ITAT)** – allowed selection of foreign AEs as tested party following subsequent years signed APA as FAR remains same.
- **AXA Technologies Shared Services Pvt. Ltd. (Bangalore ITAT)** - allowed payment of management fee at arm's length considering the subsequent year's APA

### Key takeaways:

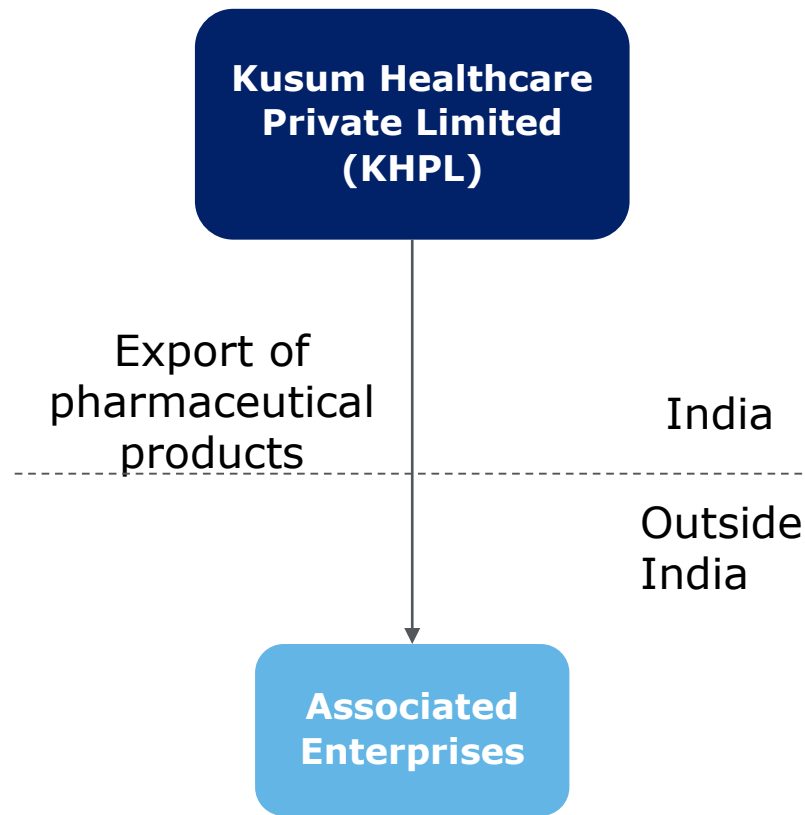
- The APA would be applicable for the year for which it has been entered into but the principles laid down in the APA can have a persuasive value **provided** the nature of international transactions and the FAR of the AE and the taxpayer remains same.
- These judicial precedents, thus, extend the benefit of arm length price /TP methodology agreed in the APA to other past years under litigation, beyond the 4 rollback years.

# Recent case laws

# **Interest on delayed receivables from the Associated Enterprises**



# Kusum Healthcare Private Limited [(2015) 62 Taxmann.com 79]



- KHPL had undertaken working capital adjustment for the comparable companies selected in its transfer pricing report. Its analysis demonstrates that the differential impact of working capital of the assessee vis-à-vis its comparables has already been factored in the profitability of the assessee, which is more than that of working capital adjusted margin of comparables.
- Hence, the ITAT held that, any further adjustment to the margins of the assessee on the pretext of outstanding receivables is unwarranted and wholly unjustified.

# Bechtel India Pvt. Ltd. ('BIPL') [(2016) 66 taxmann.com 6]

## **Facts**

- For AY 2010-11, payments on account of sales to the AE were realised after a significant time period.
- The TPO treated the delayed payments as loan facility advanced to the AEs and charged 14.88% interest for delayed period, beyond a period of 30 days.
- The aforesaid adjustment was upheld by the DRP.
- During the course of proceedings before the ITAT, it was brought to the notice that assessee was a debt free company.

## **Issue in question**

- Whether adjustment on account of receivables could be made given that the assessee was a debt free company?

## Bechtel India Pvt. Ltd. ('BIPL') [(2016) 66 taxmann.com 6]

ITAT	Delhi High Court	Supreme Court
<ul style="list-style-type: none"><li>• As BIPL was a debt free company, it was not justifiable to presume that, borrowed funds had been utilized to pass on the facility to its AEs.</li><li>• Hence, no separate adjustment for interest on receivables was warranted in the hand of the assessee</li><li>• Reliance was placed on the decision in the case of Kusum Healthcare (P.) Ltd (supra)</li></ul>	<ul style="list-style-type: none"><li>• The ITAT has returned a detailed finding of the fact that assessee was a debt free company and question of interest on receivables did not arise.</li><li>• Hence, there was no substantial question of law involved</li></ul>	<ul style="list-style-type: none"><li>• In agreement with the decision of the High Court, it was opined that ITAT has returned a finding of fact and hence, no substantial question of law arises on facts of the case.</li><li>• Accordingly, Supreme Court dismissed the SLP filed by the revenue.</li></ul>

**AY 2012-13: Delhi ITAT has upheld interest adjustment on delayed receivables from the AEs. The ITAT has noted that, interest on delayed receivables has nothing to do with the operations being with debt free funds only.**

# Advertisement Marketing and Promotion (AMP) expenses and intensity adjustment

## Decisions on AMP adjustment

<b>In favour of assessee</b>	<b>In favour of revenue</b>
<ul style="list-style-type: none"><li>• Sony Ericsson Mobile Communications India Private Limited v CIT (55 taxmann.com 240) (Delhi High Court)</li><li>• Maruti Suzuki India Limited v CIT (64 taxmann.com 150) (Delhi High Court)</li><li>• CIT v Whirlpool of India Ltd (64 taxmann.com 324)(Delhi High Court)</li><li>• Mondelez India Foods Private Limited v ACIT (70 taxmann.com 112 (Mumbai ITAT)</li><li>• Hyundai Motor India Limited v DCIT (81 taxmann.com 5) (Chennai ITAT)</li></ul>	<ul style="list-style-type: none"><li>• LG Electronics India Pvt Ltd v ACIT (29 taxmann.com 300) (Delhi ITAT)(SB)</li><li>• TVS Motor Company Ltd v ACIT (77 taxmann.com 105) (Chennai ITAT)</li><li>• DCIT v Nike India P Ltd (IT (TP) No.232/Bang/2014)(Bangalore ITAT)</li><li>• Luxottica India Eyewear Pvt Ltd v ACIT (82 taxmann.com 361)</li></ul>

# Luxottica India Eyewear Pvt Ltd [(2017) 82 taxmann.com 361]

## Facts

- The taxpayer was part of Luxottica group which was a leader in design, manufacture and distribution of sun glasses.
- The taxpayer benchmarked its international transactions of import of finished goods with Resale Price Method (RPM) as the Most Appropriate Method (MAM) for determining the Arm's Length Price (ALP).
- The Transfer Pricing Officer (TPO) opined that for the purpose of benchmarking, the comparables should also have equal intensities of the expenses incurred for sales and marketing.
- On going through the financials of the three comparable companies, the TPO noticed that they were carrying out low or negligible marketing functions.
- The TPO held that a comparability adjustment was required to be made to the profits of the comparables, before comparing their PLIs with the assessee for determining the ALP.
- The TPO, therefore, made the AMP intensity adjustment in the margins of the comparables by identifying the excess intensity of expenditure incurred by the assessee on its AMP function vis a vis such comparables.

# Luxottica India Eyewear Pvt Ltd [(2017) 82 taxmann.com 361]

## **Decision of the Delhi ITAT**

- RPM should be applied as MAM for determining the ALP of the international transaction, but, by carrying out AMP intensity adjustment in profit rate of comparables.
- If however, it turns out that such an adjustment cannot be done, due to one reason or the other then RPM should be discarded and another suitable method be adopted which encompasses the effect of AMP intensity adjustment.
- While upholding the TPOs action, the ITAT relied on the following decisions:
  - Bausch & Lomb eye care India Pvt Ltd and Ors Vs Addl and Ors [(2016) 381 ITR 227] (Delhi High Court)
  - Sony Ericsson Mobile Communications (India) Pvt Ltd vs CIT [(2015) 374 ITR 118] (Delhi High Court)



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